

QUARTERLY  
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF  
MARCH 31, 2005

Large Cap Relative Value Equity:

Abbott Laboratories (ABT)  
Cigna Corp. (CI)  
CVS Corp. (CVS)  
Fiserv Inc. (FISV)  
General Electric Co. (GE)  
Johnson & Johnson (JNJ)  
Lowe's Co. (LOW)  
McDonald's Corp. (MCD)  
Quest Diagnostics Inc. (DGX)  
US Bancorp (USB)

Mid Cap Relative Value Equity:

Bear Stearns Cos., Inc. (BSC)  
Eastman Kodak Co. (EK)  
E\*Trade Group Inc. (ET)  
Fiserv Inc. (FISV)  
Health Management Associates (HMA)  
Mercury General (MCY)  
Priceline.com Inc. (PCLN)  
Quest Diagnostics Inc. (DGX)  
Reebok International Ltd. (RBK)  
SunGard Data Systems, Inc. (SDS)

RORER  
ASSET MANAGEMENT, LLC

# THE RORER REVIEW

## DÉJÀ VU ALL OVER AGAIN

In the previous issue of *The Rorer Review*, entitled **Time To Buy Big**, we focused on our belief that inflation would remain tame by historic standards and that the U.S. economy would continue its upward trajectory, albeit at a slower pace than in 2004. We further surmised that this slower growth outlook presented investors with an attractive opportunity to purchase large capitalization stocks given their superior ability to traverse through less certain economic times. Since that report was written, interest rates and the price of oil, as well as other commodities, have continued to rise. The current consensus is that the Fed will raise interest rates for the foreseeable future. In this edition of *The Rorer Review*, we explain why we feel the current consensus is wrong, and that the Fed could end the current tightening cycle much earlier than expected.

The Federal Reserve has raised interest rates two times thus far in 2005, increasing the Fed Funds rate a total of 50 basis points to 2.75%. In its most recent statement of mid-March, the FOMC announcement noted that, while inflationary pressures had recently increased, it did not feel that inflation was likely to run away to the upside. Perhaps in anticipation of more hawkish news, the equity markets had a particularly hard time for most of March. From its high for the quarter on March 7th the S&P 500 Index fell 3.65% resulting in a 2.15% loss for the usually more upbeat first quarter of the year. The popular view is that the Fed will continue raising rates well into the future to ward off inflation, shackling the economy and dashing any hope of a rally in the stock and bond markets.

As the famous NY Yankee catcher Yogi Berra once said, "It's like Déjà vu all over again." In last summer's edition of *The Rorer Review*, titled **Temporary Inflation**, we noted that inflation had accelerated in the first part of 2004, with rising gasoline and commodity prices leading the way. Thus far in 2005, motor fuel prices are again on the rise, with costs well above \$2.00 per gallon now the norm in most of the U.S. Another example of rising prices has come from the airlines, many of which have raised fares to compensate for higher fuel expenses. Similar to 2004, anecdotal examples abound about food cost inflation. Last year we saw rising prices for milk and soda; this year it's beef and coffee.

As in 2004, we believe these early year inflationary pressures will prove to be temporary. We continue to opine that rising oil and gas prices will act as more of a tax to the consumer and a check on economic growth than a source of inflation. Higher energy prices in the past have caused consumers to cut back on spending in other areas to compensate. We see the same pattern thus far in 2005, with the growth in retail sales slowing markedly. Past spikes in the price of oil have helped produce a fairly synchronized worldwide economic slowdown. This pattern is again developing in 2005, with countries throughout Europe as well as the U.S. and Japan all reporting a falloff in economic activity. Both of these issues, as well as continued intense global competition and strong productivity growth, will help to keep inflation in check as we move forward.

We believe the U.S. economy will continue to grow in

2005, albeit at a slower pace. As mentioned above, higher oil prices will exert downward pressure on economic output. But several other factors are also at work. For one, rising U.S. interest rates have caused the money supply to contract. Thus, fewer dollars become available to fuel future expansion. Tax refunds and home refinancing activity are both well off their highs and down versus year ago comparisons. This could act as a drag on consumer spending plans in the near term. Finally, as of this writing, the equity market, with the exception of energy shares, is down year-to-date, further preying on the pocketbooks and psyches of consumers.

Notwithstanding the foregoing, there is an abundance of reasons to be optimistic. While it is understandable that the consumer might pull back a bit with the headwinds mentioned above, by most measurements the consumer is extremely well off. The healthy rise in the housing and stock markets of the past decade has helped increase consumer net worth tremendously, even as lower interest rates spurred rapid growth in mortgage debt. Further, while job creation has recently slowed in line with the economy, the unemployment rate is still a relatively low 5.2%.

Despite the inevitable slowdown, we do not believe the economies of the U.S and the rest of the world are headed into recession. Obviously, a large reason for rising energy prices is global demand. Incrementally, the developing nations of the world, most notably China, are driving the lion's share of this increased energy consumption. While China will not be impervious to slower worldwide growth, that area of the world is still expanding rapidly. This is fueling demand for all kinds of consumer and industrial goods, which will continue

to benefit companies throughout the world. Another factor is the incredible strides in productivity that have been achieved here in the U.S. As we have stated in the past, to maintain or enhance profitability in an increasingly competitive world, corporations have for years invested huge sums in technology and other capital equipment. Thanks to this, corporate profit margins are at all time highs. This strong profitability along with corporate coffers that are brimming with cash will spur ongoing investment in capital equipment for the foreseeable future.

The bottom line as we see it is that the economy will continue to decelerate for the remainder of 2005 as the dual forces of higher energy costs and higher interest rates exert themselves. However, we believe the Fed, recognizing this, will cease its tightening stance earlier than consensus expectations. In fact, we would not be surprised to see the last rate increase in this cycle occur sometime in the current quarter! Finally, we would not be shocked to see oil prices fall from the current \$55.00 per barrel area as the economies of the world decelerate.

This scenario makes us increasingly bullish on the stock market, especially for the second half of 2005 and beyond. The end of a tightening stance by the Fed has often been a lucrative time to invest in equities. Add the wild card of potentially falling oil prices, and the stock market is likely to look ahead to a reaccelerating of economic growth that we think is in store for 2006. As this unfolds we would look for outperformance in economically exposed sectors, such as technology, select industrials and finance.

We think the sledding will be tricky in the short run, however. It has become increasingly common in the past few weeks for companies to pre-announce

earnings shortfalls due to rising energy and commodity costs in the first quarter of the year. This will continue in the near term, especially for smaller companies that do not engage in hedging activities to lock in yesterday's lower prices or do not have the manufacturing flexibility and breadth of product portfolio that larger corporations possess.

We have anticipated for some time that the large capitalization stocks would begin to outperform their smaller counterparts due to this unfolding scenario. In the first quarter of this year, we began to see this as the largest capitalization stocks in the S&P 500, while still down for the period, were among the best performers in the Index. We believe that this trend will become even more pronounced in the next several quarters. At Rorer Asset Management we have consistently invested in the highest quality large capitalization stocks, buying them when they are out of favor. The current environment provides a particularly attractive time for this style of investment, in our opinion. In the first quarter of 2005, Rorer Asset Management outperformed the S&P 500. As high quality, large capitalization companies continue to generate superior earnings growth, we feel our outperformance in the first quarter is just a sign of things to come.

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